

activity for the taxable year, and the taxpayer has a net loss (within the meaning of paragraph (e)(4)(ii)(C)(3) of this section) from the well for the taxable year—

(1) The taxpayer's disqualified deductions (within the meaning of paragraph (e)(4)(ii)(C)(2) of this section) from such oil or gas well for such year shall be treated as passive activity deductions for such year (within the meaning of § 1.469-2T(d)); and

(2) A ratable portion (within the meaning of paragraph (e)(4)(ii)(C)(4) of this section) of the taxpayer's gross income from such oil or gas well for such year shall be treated as passive activity gross income for such year (within the meaning of § 1.469-2T(c)).

(B) *Coordination with rules governing the identification of disallowed passive activity deductions.* If gross income and deductions from an activity for a taxable year are treated as passive activity gross income and passive activity deductions under paragraph (e)(4)(ii)(A) of this section, such activity shall be treated as a passive activity for such year for purposes of applying paragraph (f) (2) and (4) of this section.

(C) *Meaning of certain terms.* For purposes of this paragraph (e)(4)(ii), the following terms shall have the meanings set forth below:

(1) *Allocable deductions.* The deductions allocable to a taxable year are any deductions that arise in such year (within the meaning of § 1.469-2T (d)(8)) and any deductions that are treated as deductions for such year under paragraph (f)(4) of this section.

(2) *Disqualified deductions.* The taxpayer's "disqualified deductions" from an oil or gas well for a taxable year are the taxpayer's deductions—

(i) That are attributable to such well and allocable to the taxable year; and

(ii) With respect to which economic performance (within the meaning of section 461(h), without regard to section 461 (h)(3) or (i)(2)) occurs at a time during which the taxpayer's only interest in the working interest is held through an entity that limits the taxpayer's liability with respect to the drilling or operation of such well.

(3) *Net loss.* The "net loss" of a taxpayer from an oil or gas well for a taxable year equals the amount by which

the taxpayer's deductions that are attributable to such oil or gas well and allocable to such year exceeds the gross income of the taxpayer from such well for such year.

(4) *Ratable portion.* The "ratable portion" of the taxpayer's gross income from an oil or gas well for a taxable year equals the total amount of such gross income multiplied by the fraction obtained by dividing—

(i) The disqualified deductions from such oil or gas well for the taxable year; by

(ii) The total amount of the deductions that are attributable to such oil or gas well and allocable to the taxable year.

(iii) *Examples.* The following examples illustrate the application of paragraphs (e)(4) (i) and (ii) of this section:

*Example (1).* (i) A, a calendar year individual, acquires on January 1, 1987, a general partnership interest in P, a calendar year partnership that holds a working interest in an oil or gas property. Pursuant to the partnership agreement, A is entitled to convert the general partnership interest into a limited partnership interest at any time. On December 1, 1987, pursuant to a contract with D, an independent drilling contractor, P commences drilling a single well pursuant to the working interest. Under the drilling contract, P pays D for the drilling only as the work is performed. All drilling costs are deducted by P in the year in which they are paid. At the end of 1987, A converts the general partnership interest into a limited partnership interest, effective immediately. The drilling of the well is completed on February 28, 1988. A's interest in the well would but for this paragraph (e)(4) be an interest in a passive activity.

(ii) Throughout 1987, A holds the working interest through an entity that does not limit A's liability with respect to the drilling of the well pursuant to the working interest. In 1988, however, A holds the working interest through an entity that limits A's liability with respect to the drilling and operation of the well throughout such year. Accordingly, under paragraph (e)(4)(i) of this section, A's interest in P's well is not an interest in a passive activity for 1987 but is an interest in a passive activity for 1988. Moreover, since economic performance occurs in 1987 with respect to all items of deduction for drilling costs that are allocable to 1987, A has no disqualified deductions for 1987.

*Example (2).* The facts are the same as in example (1), except that all costs of drilling under the contract with D (including costs of drilling performed after 1987) are paid before the end of 1987 and A has a net loss for 1987.